R9050-3A

TAX FOUNDATION'S VOL. 30, NO. 5 MAY 1986

TAX·FEATURES

Congress Now Costs Taxpayers Almost $2 Billion Per Year

While Gramm-Rudman-Hollings with its mandatory spending cuts hangs in the balance, Congress is planning to spend heavily on its own activities, according to recent analysis by the Tax Foundation. The budget for the Legislative Branch may increase as much as 21 percent in fiscal year 1986.

The President's budget for fiscal 1986 estimates that Congress and other Legislative Branch agencies will cost taxpayers $1.9 billion—an increase of $336 million over the $1.6 billion spent last year. Looking back ten years, Tax Foundation economists say that the 1986 budget for Congress is two and a half times what was spent on the Legislative Branch as recently as 1976, and more than eight times 1966 levels.

Ten years ago, the Tax Foundation first raised the prospect of Congress becoming "The Next Billion Dollar Bureaucracy," as a study published at that time labeled the Legislative Branch. Prediction became reality within two years, when Federal outlays for Congress broke the $1 billion mark in 1978. If current trends continue, Congress will become a $2 billion bureaucracy within the next two years, Foundation economists say.

Outlays for Congress alone will approach $922 million

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Outlays for the Legislative Branch of the Federal Government by Unit Selected Fiscal Years 1966-1986[a]
(Thousands)

Unit	1966	1976	1985	1986
Total	$231,505	$775,366	$1,609,511	$1,945,652
Congress, total	111,865	374,122	824,582	921,977
Senate	35,388	123,851	264,662	297,311
House of Representatives	68,095	197,525	462,677	472,389
Joint activities	8,382	52,746	97,243	152,277
Legislative agencies, total	119,640	401,244	784,929	1,023,675
Architect of the Capitol	26,158	57,281	107,306	169,670
Botanic Garden	497	1,235	1,983	2,331
Congressional Budget Office	—	2,763	16,056	18,058
General Accounting Office	46,136	131,778	289,751	278,957
Government Printing Office	21,662	93,391	70,487	93,868
Library of Congress	25,187	117,193	277,326	432,354
Office of Technology Assessment	—	5,035	15,889	14,589
U.S. Tax Court	—	6,919	18,881	25,850
Other	—	1,447	1,000	2,867
Deductions for offsetting receipts	—	-15,798	-13,750	-14,869

[a]Data for 1986 are estimates from the *Budget* presented in February 1986.
Source: Office of Management and Budget.

Federal Aid No Bargain; Average Cost of $1 in Aid To Twenty States—$1.19

State and local governments received $99.6 billion in Federal grants-in-aid during fiscal year 1985, an increase of $6.9 billion or 7.4 percent over the previous year, according to Tax Foundation economists.

This increase was largely attributable to substantial hikes in grants for medicaid and for highway and housing programs, they said, and was the largest in recent years. It followed a period during which Federal budget restraints sharply mitigated growth in Federal aid. As compared to annual increases averaging 15 percent during the 1970s, Federal aid since 1980 has been held to an annual average increase of just over 2 percent.

There were 328 different programs in 1985, down from 361 in 1981. The five largest are medicaid, highways, Aid to Families with Dependent Children, housing, and general revenue sharing for local governments. Together, they account for almost 53 percent of the grants disbursed, a total of $52.6 billion in 1985.

"Paying States"

While the following state-by-state analysis deals with the $99.6 billion in Federal tax costs of these programs, Tax Foundation analysts point out that this is only two-thirds of the full costs of the programs. State and local taxpayers put up another $49 billion in matching funds as a condition of receiving the grants. Total Federal, state, and local costs of the grant programs were $149 billion.

Residents of 20 states, whose Federal tax burdens exceeded the amount of grants received by their state and local governments, footed most of the bill for the grant programs going to all 50 states and the District of Columbia.

The 138 million persons residing in these "paying" states bore 61 percent of the costs—$60.9 billion to support the programs, while their state and local governments received less than $51 billion in Federal grants-in-aid. The average tax "cost" per dollar of Federal aid was $1.19.

"Receiving States"

On the other hand, the 100 million residents of the

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(*GRANTS-IN-AID, from page 1*)

remaining 30 states and the District of Columbia paid an average of 80 cents in Federal taxes for a dollar of Federal grants. These "receiving" states sent $38.7 billion in taxes to Washington and received back $48.6 billion worth of Federal aid.

For the fifth year in a row, Texans paid the highest tax premium for Federal grants. Each dollar of grants cost Texans $1.59 in Federal taxes. Other top paying states were Florida ($1.49), New Jersey ($1.42), Connecticut ($1.35), and Colorado ($1.28).

At the low end, residents of the Nation's Capital paid 35 cents for a dollar of Federal aid. Favorable balances also prevailed in South Dakota (48 cents), Montana (53 cents), Vermont (54 cents), and Alaska (54 cents).

Tax Foundation's Formula

Tax Foundation's method for deriving the Federal tax burdens borne by residents of each state is designed to show where tax dollars actually originate, rather than where they are collected. The data on grants-in-aid are shown as reported by the Bureau of the Census.

Tax Foundation analysts point out that these comparisons of Federal tax burdens for aid assistance do not reflect the entire costs incurred by state and local governments for obtaining grants. The comparisons, with few exceptions, do not take into account the costs to these governments of administering the programs for which the aid is granted, nor the amounts of matching funds which the state and local governments must make available out of their own revenues in order to qualify as recipients of these grants.

State-Local Costs

For fiscal year 1985, the Administration estimates that state and local governments provided about 50 cents of matching funds for each $1.00 of Federal aid. This matching share is up from 37 cents per $1.00 in 1980, because of significant growth in programs such as medicaid that require a larger than average matching share. Based on these matching shares, as reported in the Budget for fiscal year 1987, Tax Foundation analysts calculate that state-local matching costs of Federal grant programs rose by $17 billion (51 percent) from 1980 to 1985, while Federal grant disbursements rose by $11 billion (12 percent).

The accompanying table provides state-by-state data on Federal grants as compared to Federal tax costs.

Further details are provided in the ***"Memorandum on the Allocation of the Federal Tax Burden and Federal Grants-in-Aid by State, Fiscal Year 1985,"*** available from Tax Foundation for $4.00 (plus $1.00 postage and handling per order).

Federal Grants-in-Aid to State and Local Governments and Estimated Federal Tax Burden for Federal Grants

Fiscal Year 1985

State	Grants[a] (millions)	Percent of total tax burden	Estimated tax burden for grants[b] (millions)	Tax burden per dollar of aid	
				Amount	Rank
TOTAL U.S.	$99,622.5	100.00	$99,622.5	$1.00	—
Alabama	1,674.4	1.27	1,263.3	.75	34
Alaska	609.6	.33	330.6	.54	47
Arizona	1,106.4	1.17	1,161.4	1.05	13
Arkansas	1,005.5	.71	703.7	.70	40
California	10,492.4	12.15	12,102.8	1.15	8
Colorado	1,113.6	1.43	1,429.3	1.28	5
Connecticut	1,377.4	1.87	1,865.1	1.35	4
Delaware	318.0	.28	280.0	.88	29
Florida	3,117.8	4.68	4,659.0	1.49	2
Georgia	2,366.8	2.17	2,161.9	.91	26
Hawaii	435.6	.42	417.6	.96	23
Idaho	425.0	.31	305.9	.72	38
Illinois	4,687.5	5.42	5,403.2	1.15	9
Indiana	1,825.1	2.10	2,094.6	1.15	10
Iowa	1,163.5	1.14	1,134.5	.98	21
Kansas	854.5	1.05	1,050.3	1.23	6
Kentucky	1,749.8	1.20	1,193.9	.68	41
Louisiana	1,779.4	1.62	1,618.1	.91	27
Maine	659.3	.39	386.4	.59	46
Maryland	2,058.4	2.14	2,133.6	1.04	15
Massachusetts	2,842.0	2.88	2,872.0	1.01	19
Michigan	3,958.7	3.70	3,681.2	.93	24
Minnesota	1,980.2	1.76	1,753.6	.89	28
Mississippi	1,167.1	.70	694.8	.60	45
Missouri	1,932.4	1.99	1,983.5	1.03	18
Montana	545.5	.29	287.2	.53	49
Nebraska	674.6	.62	622.5	.92	25
Nevada	371.4	.42	422.5	1.14	11
New Hampshire	418.2	.44	441.2	1.05	12
New Jersey	2,945.2	4.20	4,185.1	1.42	3
New Mexico	728.5	.48	478.7	.66	42
New York	11,092.3	8.35	8,320.8	.75	35
North Carolina	2,131.0	2.15	2,138.1	1.00	20
North Dakota	434.1	.27	265.3	.61	44
Ohio	4,157.9	4.32	4,305.3	1.04	16
Oklahoma	1,229.9	1.28	1,278.1	1.04	14
Oregon	1,240.1	.99	989.6	.80	32
Pennsylvania	4,961.4	4.83	4,816.4	.97	22
Rhode Island	573.2	.41	406.8	.71	39
South Carolina	1,320.8	1.04	1,038.0	.79	33
South Dakota	476.2	.23	230.4	.48	50
Tennessee	1,931.4	1.64	1,629.7	.84	31
Texas	4,469.8	7.13	7,099.8	1.59	1
Utah	714.7	.52	515.3	.72	37
Vermont	336.1	.18	180.6	.54	48
Virginia	2,049.7	2.44	2,430.1	1.19	7
Washington	1,798.5	1.87	1,858.3	1.03	17
West Virginia	902.9	.59	587.5	.65	43
Wisconsin	2,109.9	1.85	1,847.1	.88	30
Wyoming	293.7	.22	215.9	.74	36
District of Columbia	1,018.0	.35	352.0	.35	51

[a]Excludes shared revenues and payments in lieu of taxes; includes General Revenue Sharing and trust fund aids.
[b]The total tax burden for grants is assumed to equal grant payments.
Source: U.S. Department of Commerce, Bureau of the Census; and Tax Foundation computations.

Tax Features

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FEDERAL TAX POLICY MEMO

Editor: Edward A. Sprague, Senior Vice President—Program Planning and Tax Policy

MAY 1986

Minimum Tax—Maximum Tangle

The Senate is being driven more and more forcefully into the minimum tax box, which is finishing off any hope of real tax simplification in the current reform round. The alternative minimum tax is justified most commonly to make all corporations and upper-income individuals "pay their fair share" of tax liability. This carries political weight, to be sure. But now it has been joined by an overarching need for more revenue to balance up the reform package. Because the Finance Committee has been busy stripping away money-raising provisions from Chairman Packwood's draft proposal—and because a lot of the excisions here are likely to stick throughout the Senate consideration—the reformers are desperate for more money from other sources. ***Even if the tax reform program goes down the tube, the alternative minimum tax undoubtedly will remain as a likely revenue plug to dress up the budget deficit.***

Chairman Packwood's alternative minimum tax proposal was originally estimated to raise $46 billion over five years—$25 billion from individuals and $21 billion from corporations. This would be much stiffer than the House tax reform provision in H.R. 3838, particularly in the corporate area. Part of the stiffening was the proposed inclusion of all tax-exempt interest in the minimum tax base. That idea lasted about 24 hours before the collapse in the municipal bond market threw it out of contention. There is still a good chance that some tax-exempt income from "nonessential function bonds"—those subject to volume limitations—may be included, as in H.R. 3838. Another feature of the draft Senate legislation would be to include one-half of book income over the minimum tax base to that point as a preference item. This represents a new direction for the minimum tax concept attempting to reach a broader measure of "economic income," either in *addition to*, or perhaps as a *substitute for*, the rather mixed bag of specific items making up the present minimum tax base. As the search for more revenue intensifies, this direction is likely to be explored further.

Either way, the minimum tax can complicate tax life immensely for millions of individuals and corporations. Under either House or draft Senate version, it would reach well beyond upper-income individuals and corporate tax avoiders. It would hit middle-income individuals with relatively minor participation in tax shelters, emerging corporations without established profit histories, and corporations in cyclical industries who paid little or no tax in dry years but had substantial such liability over a longer period. Furthermore, virtually all corporations and millions of individual taxpayers would have to *contend* with the tax; would have to calculate potential liability even if none actually was incurred. A recent Arthur Andersen report indicated that 8 or 9 major new calculations would be necessary to comply with the House or Senate version of the individual alternative minimum tax.

While we know it would be much more complicated, we don't know really what specific economic impact these minimum taxes would have. The revenue estimates must be viewed with great suspicion. On the corporate side, the impact could be quite erratic depending on the stability of the firm's profits, its adaptability to merger or acquisition, its use of the preference provisions, and, under the Senate version, financial accounting practices heretofore having no direct bearing on tax liability. The effect on the marginal tax rate of firms subject to the alternative minimum tax could be considerably greater than a direct reduction in the preference provisions. And, in the case of incentive deductions, as opposed to credits, the increase in the firm's marginal tax rate occasioned by the minimum tax could be larger than the minimum tax rate itself. While it is difficult to generalize about industry impacts, clearly such a minimum tax would bear harder on firms with low profit margins, even if they were fast growing and not necessarily heavy users of preference items. Also, under the House version, the minimum tax rate of 25 percent on an expanded preference base would be only 11 percentage points below the proposed regular rate of 36 percent. The compression of the two rate structures would tend to push numerous firms into minimum tax liability with no certainty as to a comparable increase in their "economic" income, however defined, to bear higher taxes.

Historical Note

The minimum tax has been with us since the Tax Reform Act of 1969. The genesis was the same "fairness" issue that continues to attract attention today. After the last Secretary of the Treasury in the Johnson Administration, Joe Barr, made his famous reference to the 154 individuals making over $200,000 in adjusted gross income who paid no income tax, the hunt was on. A minimum tax was concocted as the easiest way to get at the tax avoiders without the political pain of having to revise all the special provisions of the Code directly. Revenue wasn't much of a factor, and, initially, there was no intention to apply the minimum tax to the corporate sector. During the Senate consideration of the 1969 bill, however, the focus was changed from an alternative to an add-on minimum tax, and corporations were targeted, too.

Under the 1976 Tax Reform Act, the minimum tax was tightened substantially: the rate was raised to 15 percent, additional items of preference income were added to the base, and, for individuals, the minimum tax deduction for regular taxes paid was cut in half. By 1978, this add-on tax was beginning to bite both individuals and corporations. Although total minimum tax collections were still under $2 billion, there were a lot of objections to the add-on feature, particularly as it could subject individuals with occasional large capital gains to a minimum tax penalty even while making fairly hefty regular tax payments. Having preference income also could "poison" an individual's ability to take advantage of the then maximum tax

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rate of 50 percent on earned income. There was a much greater than intended restriction of the use of the maximum tax process because of this factor. Therefore, under the 1978 Act, the individual preference items for capital gains and "excess" itemized deductions—which were the big target items in the minimum tax base—were pulled out of the add-on tax and subjected to a separate but true alternative minimum tax with graduated rates. Finally, under the 1982 bill (TEFRA), the individual add-on tax was repealed entirely and all preferences, including a few new ones, were thrown into the alternative minimum tax base subject to a flat 20 percent rate.

On the corporate side, the add-on tax has remained in roughly the same structural form, although there has been a general tightening trend coordinated with the scaleback of preference items directly under the 1982 and 1984 tax bills. In overall revenues, the corporate minimum tax has not been a very significant factor, but it has had a severe impact on some industries, such as mining, and produced large headaches for tax planners, especially those in cyclical industries after 1976 when the carryover of regular taxes as a deduction from the minimum tax was repealed.[1]

New Issues

As we contemplate a broader minimum tax, a little bit of the controversy accompanying its checkered career in the 1970s and early 1980s appears to have been resolved. But much of it remains and new issues crop up. There does seem to be agreement that further development of the minimum tax should be on a true alternative basis—that is, the individual or corporate taxpayer would pay it only if its regular tax liability is lower. This accords with the basic mission of the minimum tax—to ensure some tax payment by all with significant economic income—and, most would agree, is intrinsically more equitable than the add-on type of tax. But there is still a large problem of integrating the two structures.

In fact, an alternative corporate minimum tax probably would be more volatile than the present add-on system. There would need to be more careful consideration of carryovers of net operating losses and credits to ensure that taxpayers are not hit capriciously with penalties because of uneven economic performance or past investment decisions. H.R. 3838, for example, does permit incentive credits, such as the investment credit and R & D credit, to offset minimum tax liability, but only in cases where the taxpayer had net operating losses in two of the last three years. This could curtail the benefit of the credits for investments entered into before the alternative minimum tax became a factor and even when the taxpayer had no preference income at all. Retroactive application of the alternative minimum tax to individuals could result from the inclusion of so-called "passive" investment losses in the preference base. It is very difficult to distinguish, for minimum tax or other purposes, between tax motivated losses and those occasioned by profit motivated investments that happened to yield economic losses. But the Senate is plunging on, even considering adding some direct business losses to passive losses as preferences.

[1]For a more thorough history of minimum taxes, see "Background Analysis of Corporate Minimum Tax Issues," staff working paper, Congressional Budget Office, July 1985.

By far the most significant issue is the potential expansion of the minimum tax base to sweep in more broadly defined economic income. The House measure does this to some extent, particularly with respect to the proposed inclusion of tax-exempt income from "non-essential function" bonds and passive investment losses in the base. The draft Senate version takes a larger jump by including half of book income over the minimum tax base to that point in the corporate minimum tax. Other proposals would use corporate earnings and profits as a proxy for economic income or even net business receipts.

It can be argued, of course, that a very broad-based minimum tax at a low rate would be more equitable and involve less distortions than a high-rate tax centered on selective preference items such as under H.R. 3838. According to the Congressional Budget Office, we could raise $35 billion over five years from a 2-½ percent add-on corporate minimum tax on economic income defined as gross business receipts less allowable expenses (wages and salaries, cost of materials, payments to qualified pension plans, and straight-line depreciation of assets) then reduced further by regular tax liability and a $100,000 exclusion. Presumably, we could quite easily raise billions more by jiggling the rate a percentage point or two. It might be quite a good revenue source but would almost completely disregard the current concept of when and where it is appropriate to impose a rate of tax. It might be easier to go whole hog and set up a separate value-added tax.

Using book income as part of the minimum tax base involves a host of complications not the least of which would be giving the accountants and generally accepted accounting standards partial responsibility for defining taxable income. What you do about nonpublic companies, varying rules and degrees of consolidation for book income, foreign subsidiaries and all kinds of other necessary adjustments could produce extreme pressure on financial accounting.

***

Unfortunately, no excursion into constructing a "strong" minimum tax is without major complication of the system. All minimum taxes diminish the value of the special tax provisions included in their base to some extent—provisions that Congress agreed to for presumably worthwhile social and economic objectives. ***Even if one accepts the argument that some devaluation of tax preferences is necessary in order to ensure fuller participation in paying income tax liability, major considerations of basic equity and economic impact dictate a lot of coordination with the regular income tax—necessary adjustments for credits and net operating loss carryovers or basis adjustment in the case of deferral preferences such as accelerated depreciation. Otherwise a "strong" alternative minimum tax can result in taxation where there may be no real economic income or a minimum tax penalty greater than the value of the preference itself—a form of double taxation.***

One must ask also whether the objective of ensuring tax liability for *all* with economic income can be achieved practically through the minimum tax mechanism. We have witnessed the extreme difficulty subjecting tax-exempt bond interest to any new tax. It would be perfectly possible under either the House or draft Senate bills for upper-income individuals to rely on tax-exempt interest for a major source of

income and continue to pay little or no tax regardless of an otherwise powerful minimum tax.

In past reports we have examined some of the ways tax policy can address directly the issue of tax avoidance through shelter investments—and how the market itself disciplines such investment—without resorting to the blunderbuss weapon of the minimum tax. We also observed that the existing income tax structure, flawed as it may be, is still progressive on the individual side and does reach an awful lot of high-income folks for significant tax bites. Statistically, the numbers in the upper-income group that escape entirely or pay less than a 5 percent effective rate are a very small minority. As for the corporate side, there are those firms which, for one reason or another, pay little or no income tax, and rates of effective tax on corporate income have declined. But particularly when one factors in the effect of state/local and payroll taxes, corporate tax burdens are still very substantial.

If fairness cannot be fully served by resort to the minimum tax or only served with economic dislocation and extreme complication, what would justify setting up a whole new system of income taxation to parallel the somewhat creaky present one? If it is merely the additional revenue projected, is there a better way to deal with that? Congress does seem determined to enact a bigger minimum tax, but it ought to keep asking, at what price?

*****

Tax Reform—Probing the Process

In the current mode of tax reform, Congress is being asked to make many sweeping changes in the structure all at once, in a single, if not very neatly arranged, package. There are obvious reasons for going this route. Because rate reductions and an increase in the personal exemption have been made central priorities, keeping the package revenue neutral, at least on paper, almost requires looking at everything for base-broadening potential. Most players in the process say they need the revenue-neutral discipline to move the program and prevent it from degenerating into a slew of revenue-losing exemptions.

Past efforts at tax reform in 1969 and 1976 did not attempt to comb through the entire Code and ended up as net tax reductions. Of course, we didn't have such a budget deficit fixation then. It wasn't deemed that important to balance the program.

Now Congress finds itself about two-thirds of the way through the reform process, still trying to keep everything under one tent, but, obviously, running out of base-broadening or other options to preserve that revenue neutrality. Some of this is inevitable as the more elegantly structured plans of tax reformers are ground through the legislative mill. The proposals that set off the loudest howls—such as disallowing state/local tax deductions—are dropped or modified, and there is a scramble to find new revenue sources—such as excise taxes—which in turn sets off new howls.

There is a tendency in the popular press to blame the "special interest" lobbyists for sullying the concept of tax reform in this matter. A recent* Time *cover story bemoaned the influence of swarms of lobbyists descending on Washington, lining up in "Gucci Gulch," outside the Ways and Means Committee offices. Which must strike many individual lobbyists as cruelly ironic. If they had so much power, why were they standing out in the hall? And why would they have to contend with such legislation at all? The fact that tax reform is still alive in the U.S. Senate (at this writing) and still contains many provisions to impose new tax burdens on various economic sectors—mostly on business sectors—would hardly indicate that the business interests are calling all the shots.

But the fact of the matter is that Congressmen, including members of the Ways and Means and Senate Finance Committees, are simply not equipped to deal with the mass of proposed changes affecting so many aspects of economic life, especially at one time. Many of the proposals involve extremely complicated areas of the Code. (Who really understands and can explain taxation of the insurance industry?) Often to scrounge more revenue they would make it even more complicated. ***No matter how good the staffs, it is simply impossible for individual Congressmen and Senators to master all the economic and social implications. Therefore, they really need the reaction of the "lobbyists," or whoever is representing the affected taxpayers, to gauge the importance of various proposals—not to mention the chances of being blindsided at the next election.*** Otherwise, they are almost entirely dependent on what they have gleaned from the hearing process and, of course, Treasury and congressional staffs.

In fact, in a bill so cumbersome as H.R. 3838, there are a number of areas where Congress has not heard *enough* from the affected parties and where it has relied perhaps too much on staff assertions and staff revenue estimates. Ready examples may be found in the retirement income provisions.

Pension Problems

The tax treatment of retirement income had been visited repeatedly by major legislation in 1974, 1978, 1982, and 1984. The urgency of further reforms would seem questionable. But both the President's program and the House bill put forth a whole slew of them. Despite Chairman Packwood's earlier statement that the employee benefits area should be left alone, the draft Senate Finance program devoted a full 20 percent of its pages to retirement income and employee benefits changes. Much of the press coverage and congressional attention here have been on 401(k) plans, which have many defenders and seem sure to survive, albeit, perhaps in less useful form. Some other areas have received much less attention or less *effective* attention.

Both the House reform bill and the draft Senate bill would tighten the limitations on contributions and benefits under qualified plans, including a more comprehensive combined limit on distributions from all tax-deferred plans and a 15

percent excise tax on aggregate "excess" distributions. The House measure, in particular, is more restrictive of defined contribution plans. The present $30,000 limit on annual additions would be reduced to the greater of $25,000 or 25 percent of the defined benefit plan limitation—which in turn would be lowered from $90,000 to $77,000 under the bill. The cost-of-living adjustment to the $25,000 limit on defined contribution plans would be suspended until the limit reaches 25 percent of the defined benefit limit. If inflation is a "modest" 4 percent annually, that would take seven years with the defined contribution limit effectively frozen at $25,000. There is no separate revenue estimate for this distinction, but the combination of Section 415 limitations is expected to raise about $1.7 billion over five years.

A $25,000 top on defined contributions is not likely to affect a great mass of participants, at least not in the immediate future, and has not produced much of a hue and cry. The House bill's rationale, however, seems quite arbitrary. According to the House Ways and Means Committee Report, the Committee deliberately wanted to favor defined benefit plans, alleging that they provide "better overall retirement security" because the participants are protected against bad investment experience, and, with most benefits based on final average pay, better protected against inflation.

It's probably true that defined benefit plans are more suited for long-service workers in stable employment situations with the expectation of fairly steadily rising income. But they are not that well suited where employee turnover is high, such as in the service trades, and many other areas of the economy where the greatest growth in employment has occurred. Employees who change jobs with some frequency, but still vest their pension rights, are likely to do considerably better under defined contribution plans, where they at least have the continuing benefit of accrued interest earnings, than under defined benefit plans with the same vesting schedule but which can make no allowance for earlier periods of coverage. It is obviously easier to introduce more portability—or effective vesting protection—into defined contribution plans. Interest earnings under such plans also will reflect inflation trends as interest rates tend to rise and fall in rough correlation with the inflation rate. (Typically, neither type of plan offers any guarantee against inflation, nor is it necessarily advisable to attempt to do so.) Lastly, while it is true that participants in defined benefit plans are shielded from bad investment experience to the extent that the employer is responsible for set results and the Pension Benefit Guarantee Corporation is there to back up shaky plans, it's also true that the plan participants may not benefit at all from *above average* investment experience. In the case of defined contribution plans, both above average and below average investment performance will flow directly to the account of the participant.

The real point is not that one type of plan is better than the other, but that they serve different needs and that the parties thereto should be in the best position to judge their applicability. Certainly, it can be argued that tax-deferred plans should be subject to some limitation on amounts contributed or distributed. But to favor one plan over another for policy purposes would seem to demand further explanation and exploration of the issues than given in the House Report.

In respect to limitation of *employer* contributions, both the House and draft Senate bills extend the 25 percent of total compensation limit under Section 404 to *any* combination of a deferred benefit plan and defined contribution plan. This is proposed in the name of uniform treatment. The problem is that the economic context of recent years has forced many employers to reduce their work forces significantly and, thereby, incur significant increases in unfunded liabilities under their primary defined benefit plans. With the need for additional contributions to fund these defined benefit plans, employer contributions to money purchase pension plans could be squeezed out by the more stringent limits. Again, it is not necessarily the concept of some limitation that is at issue, but its potential harsh application.

Incremental Approach Next Time

These two examples only scratch the underside of the questions raised about proposed pension and retirement income changes. There are a lot more, and some more prominent, with respect to tax-deferred savings, lump sum distributions, asset reversion to employers, etc. A number of them were covered in our Working Paper, *Tax Treatment of Retirement Savings—Success Under Attack*, of December 1985.

Our examples do serve to underscore two broader problems of tax reform. One, and most obvious, the objective of absolute uniform treatment is very difficult to apply in a diverse economy because market sectors are not uniform and rigid rules for all cases inevitably will choke off market response. Two, less remarked but quite important, ***Congress simply doesn't have the time or leeway under the present modus operandi to examine with appropriate thoroughness all the issues involved. Provisions attracting the most heat will be modified, but others, perhaps more, or no less, deserving of modification in terms of sound policy choices, will not be examined because of the need to maintain revenue plugs and/or because the Committee must press on with its schedule.***

What this would argue for in the inevitable next round of reform, whether that is to pick up what is not accomplished, or to repair what is accomplished, in this round, would be a more deliberate, incremental approach. The danger of dangling large individual tax reductions as the target for the reform movement is now more apparent. As worthy as the objective of rate reduction is, the manner in which the carrot has been offered has set off an across-the-board scramble for makeup revenue that does not do justice to policy choices.

Tax Index Hits 529.4: Nation's 1985 Tax Bill Is Nearly $1.2 Trillion

The Tax Index climbed to a new high of 529.4 in 1985 (1967 = 100), as the nation's total tax bill hit $1.172 trillion, more than five times the level recorded for the base year 1967.

The total—which includes Federal, state, and local taxes—reflects a rise of $84.3 billion, or 7.7 percent in calendar year 1985 over the previous year.

The increase in taxes was 2.0 percentage points (35 percent) higher than the concurrent 5.7 percent gain in the Gross National Product (GNP), the gross market value of goods and services. (Inflation-adjusted GNP rose 2.2 percent, and general prices, 3.3 percent during the year.)

The Tax Index is a fiscal yardstick designed by Tax Foundation economists to provide a continuing measure of trends in taxes, on a basis comparable to official indexes for other segments of the economy.

Since 1982, the year in which the last recession bottomed out, the annual Tax Index has risen from 421.6 to 529.4 (1967 = 100), or 25.6 percent. Although the Economic Recovery Tax Act of 1981 (ERTA) slowed their rise, Federal taxes have gone up over 23 percent since 1982. State-local taxes have risen faster, by just over 30 percent. The growth pattern in the overall Tax Index has been virtually the same as the 26 percent gain in GNP over the same period.

Among the separate components of the Tax Index, the corporate profits index has scored the largest percentage gain since 1982. It has climbed by 35 percent. (The corporate index is also the most volatile index component because of the sensitivity of corporate profits to the business cycle.) Its rate of growth was followed by an increase of 32 percent in the social insurance taxes index; 26 percent in indirect business taxes (property, sales, selective excises); 20 percent in the personal income tax index; and 3 percent in the index for all other taxes.

Measured against the 1967 base year, contributions for social insurance have outpaced all other types of taxes, reaching a 1985 index of 785.6. The Federal index of 805.8, which covers the lion's share of social insurance levies, is running well ahead of the state-local index of 671.6.

The next highest growth since 1967 has occurred in personal income taxes,

(Continued on page 4)

THE FRONT BURNER

By Robert C. Brown, President
Tax Foundation, Incorporated

"CPI Minus 2 Revisited"

Some ideas, like vintage wine, have to mature. CPI Minus 2 may be just such an idea.

Originally introduced in 1983 by Rep. James R. Jones of Oklahoma, then Chairman of the House Budget Committee, CPI Minus 2 was a shorthand label for a new approach to fiscal policy. In essence, Jones sought to put a lid on the growth of inflation-adjusted entitlement benefits and a floor under the rates of inflation-adjusted tax tables. He saw a major flaw in fully indexing entitlements to the consumer price index (CPI), which was compounded when indexing was applied to the tax bracket tables under the 1981 tax bill.

Indexing allows old age, survivors, and disability insurance; armed services retirement; civil service retirement; Federal worker compensation for job-related injuries; and railroad retirement—so-called entitlements—to grow automatically with inflation. Tax indexing shields taxpayers from the ratcheting effect of inflation on the tax rate brackets and personal exemptions.

The net effect is a two-way squeeze on the Federal budget—indexing automatically increases benefit levels and simultaneously holds down revenue growth. Indexing can overcorrect, compounding the shortfall between outlays and revenues.

CPI Minus 2 would reduce the spending and tax adjustments by two percentage points. This would trim the budget deficit but still allow good protection against really high inflation, should that recur.

CPI Minus 2 would also have a number of other beneficial effects:

1) The sacrifice would be shared about equally by those who receive income from the Federal programs and those whose income is taxed to fund the programs.

2) The impact on deficit reduction would be permanent and cumulative, even if inflation stays moderate. A dollar saved in 1986 becomes a lot more saved in 1990—especially when you count the interest that would have to be paid on that dollar if it were part of the national debt for four years.

3) The savings are structural—built into both the spending programs and the tax rates. They work toward deficit reduction just as automatically as indexing now works against it.

Given the stubbornness of the deficits and the inability of Congress to meet the first Gramm-Rudman-Hollings target on April 15, perhaps CPI Minus 2 has aged long enough. Let's tap the cask, and see whether, like fine burgundy, its time has indeed come.

(*COST OF CONGRESS, from page 1*)
in 1986—$297 million for the Senate and $472 million for the House of Representatives. Per Senator, that translates into about $3 million; $1.1 million, per U.S. Representative.

Joint activities of both Houses of Congress will run up costs of $152 million this year—a whopping 57 percent above 1985 outlays, according to researchers at the Washington-based tax watchdog organization. Most of the increase, they say, is due to a proposed rise of $55 million in official mail costs, part of which is still pending in Congress. Congress wants to spend $141 million for its 1986 official mail costs. Joint activities of both Houses will add nearly another $285,000 per Member of Congress.

Various other legislative agencies will spend an additional $1.2 billion, a rise of 30 percent, or $239 million, over 1985.

The table on page 1 provides details.

"Working Papers and Other Reports"

"Working Paper" Series: $3.00 each. Members $5.00 each. Nonmembers—includes postage and handling. Order from Publications Department, Tax Foundation, (202) 822-9050.

"Tax Reform—Probing the Process," April 1986, 8 p.

"Business Tax Burdens—II," January 1986, 6 p.

"The House Tax Bill," January 1986, 15 p.

"Gramm-Rudman-Hollings: A Bad Idea Whose Time Has Come," December 1985, 8 p.

(Summaries of some of these papers may appear as articles in *Tax Features* or in *Federal Tax Policy Memo*.)

"Achievability of Fiscal 1987 Budget Targets," A Report by The Shadow Committee on the Federal Budget, Tax Foundation, March 1986, 16 p. Single copies free.

(*TAX INDEX, from page 3*)
the largest single revenue producer among all tax sources. Reflecting collections of $417.3 billion, the personal income tax index stood at 591.9 in 1985. State-local personal income taxes are now more than 12 times their 1967 base, at an index of 1202.6. The Federal index for personal income taxes has more than quintupled, rising to 533.7. These trends reflect a long-time tendency for state-local personal income taxes to grow relative to those in the Federal sector; in 1967 personal income taxes of subnational levels of government were less than 10 percent of the amounts collected by the Federal government. By 1985, state-local personal income taxes were more than 20 percent of the Federal personal income tax take.

The table below provides additional details for the Tax Index and its Federal and state-local components.

Tax Index by Level of Government and Type of Tax, Selected Periods 1980-1985[a]

Index Numbers, 1967 = 100

Type of tax	1980	1981	1982	1983	1984	1985
All governments						
All taxes	364.0	414.9	421.6	445.0	491.4	529.4
Personal income	416.6	481.7	494.2	492.1	528.5	591.9
Corporate profits	260.1	248.8	193.3	230.7	287.1	261.0
Indirect business[b]	295.4	347.4	355.1	386.7	423.0	448.7
Social insurance contributions	479.3	556.8	596.6	643.9	719.4	785.2
All other[c]	237.5	251.6	273.4	254.7	262.5	282.8
Federal government						
All taxes	362.4	418.5	414.6	429.5	472.8	511.6
Personal income	389.9	453.0	460.4	448.1	473.4	533.7
Corporate profits	234.3	219.0	163.3	197.7	248.0	223.7
Indirect business[b]	223.7	330.9	271.7	295.4	316.4	314.5
Social insurance contributions	485.7	569.5	607.7	656.0	736.9	805.8
All other[c]	212.9	225.8	245.2	190.3	190.3	209.7
State and local governments						
All taxes	367.3	407.2	436.6	477.9	530.7	568.0
Personal income	698.4	785.2	850.8	955.7	1,109.8	1,206.6
Corporate profits	557.7	592.3	538.5	611.5	738.5	692.3
Indirect business[b]	316.3	352.2	379.3	413.2	453.9	487.8
Social insurance contributions	443.3	485.1	534.3	576.1	620.9	671.6
All other[c]	260.6	275.8	300.0	315.2	330.3	351.5

[a]Most taxes are shown on an accrual basis.
[b]Includes sales, excise, and customs levies, and real property taxes (including those on owner-occupied homes).
[c]Estate and gift and personal property taxes.
Source: Tax Foundation computations based on data from the U.S. Department of Commerce, Bureau of Economic Analysis.

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